

KNOW YOUR BORROWER:

The Four Need Cases of Small-Dollar Credit Consumers

December 2013

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EXECUTIVE SUMMARY:

An increasing number of Americans are turning to nontraditional credit sources for quick access to cash. Every year, an estimated 15 million people access small-dollar credit (SDC) products—defined in this report as payday loans, pawn loans, deposit advance loans, auto title loans, and non-bank installment loans—to meet their financial needs. And tens of millions more rely on subprime credit cards, checking account overdrafts, and other expensive forms of credit when their access to traditional credit is limited.

There is a critical market need for consumer-focused innovations to develop high-quality financial services that could help meet this demand for short-term liquidity without the risks posed by many SDC products. To date, however, high-quality innovation in the SDC market has been limited by a lack of objective, data-driven research on consumers' experiences and points of view regarding SDC products.

In response, the Center for Financial Services Innovation (CFSI), with support from the Ford Foundation, has undertaken extensive consumer research to examine the needs, decisions, and experiences of SDC consumers, with the goal of promoting the development of high-quality SDC solutions. As CFSI defines it, high-quality credit is affordable, marketed transparently, priced fairly, structured to support repayment without creating a cycle of repeat borrowing, and supports credit-building.

This report explores the financial needs that drive borrowers' demand for credit—the necessary starting point for a detailed understanding of the consumer and the marketplace. It builds on previous research to more comprehensively identify and classify the major categories of financial need that form the marketplace for nontraditional small-dollar credit.

The Four Consumer Need Cases

This research utilizes a consumer needs analysis based on a panel survey of more than 1,100 SDC borrowers (quantitative data) and 31 in-depth interviews with SDC customers (qualitative data) to identify *need cases*, or primary categories of financial need that lead consumers to use small-dollar credit. CFSI finds four primary need cases in the SDC market, each corresponding to a different borrower profile and use of small-dollar credit.



1. **Unexpected Expense** borrowers access small-dollar credit somewhat infrequently for relatively larger expenses related to an unexpected or emergency event.
 - These borrowers use a wide range of SDC products and are significantly more likely to borrow in order to repair a car, pay medical bills, make home repairs, and help family or friends.
 - Many are not regular small-dollar credit borrowers: 47% of Unexpected Expense borrowers take out only one or two loans per year.
 - Although facing constrained access to traditional credit, a third (32%) of these borrowers have some savings at the time of their SDC loan and more stable finances.



2. **Misaligned Cash Flow** borrowers tend to access smaller credit amounts frequently to pay bills when income and expenses are mistimed. These cash flow shortfalls may occur because borrowers have a low income, variable income flows, or financial management issues.
 - Misaligned Cash Flow borrowers frequently use payday loans and other very short-term credit to pay utilities, rent, and household expenses.
 - They tend to be among the most credit dependent users. Approximately half are moderate to heavy credit users: 42% take

out 6 or more loans per year, and 16% take out more than 12 loans per year.

- Although their cash flow shortages are recurring, they are usually short-term. Chronic income shortfalls may indicate that borrowers are exceeding their income.



3. **Exceeding Income** borrowers have expenses that regularly exceed their income and are also among the heaviest users of credit, accessing smaller loan amounts for everyday expenses.
 - These borrowers are the most likely to use payday and pawn loans for general living expenses, such as food and clothing.
 - They tend to borrow the smallest loan amounts. More than three-quarters (77%) of loans were under \$500, and 30% were under \$100.
 - Exceeding Income borrowers are the most likely to use very short-term credit repeatedly and may roll over their loans more often.



4. **Planned Purchase** borrowers occupy a unique niche in the SDC market, using small-dollar credit to make a relatively large, planned purchase, often related to a personal asset.
 - Planned Purchase borrowers use installment loans most commonly to purchase a car, make home repairs, buy furniture and appliances, and cover small business expenses.
 - They are the least frequent borrowers but access the largest loan amounts in the SDC market. Half (51%) of Planner Purchase borrowers take out only one or two loans per year, and a similar number (50%) borrow more than \$1,000 per loan.
 - Planned Purchase borrowers tend to be the most financially stable SDC users. They have the highest average household income levels, and a majority (65%) have some savings at the time of the loan.

Meeting the Needs of Small-Dollar Credit Consumers

The multiple need cases in the SDC market indicate that there is no one-size-fits-all solution to consumer credit. It is clear from the research that many SDC consumers could benefit from financial management solutions and innovative approaches to help them better budget and save. Financial services that help consumers reduce cash flow shortages and establish emergency savings have great potential to address the underlying financial needs that drive many SDC consumers to use credit.


The analysis also suggests that a variety of safe, affordable, high-quality credit products are necessary to meet some of the need cases in the SDC market. The potential exists to customize credit products according to the varying loan structures, terms, amounts, and uses documented in this analysis. For example, Unexpected Expense borrowers may benefit from amortized installment loans with extended terms, whereas borrowers who need small-dollar credit more often, such as Misaligned Cash Flow borrowers, may be better served through flexible, low-limit credit lines structured to support repayment.

This research highlights the critical issues of credit affordability and ability to repay debt. Better underwriting—a streamlined process to capture and analyze a borrower's recent expenses and debt payments history—could more accurately identify underlying needs and provide a solid foundation for new and better products designed to improve consumer outcomes. Furthermore, by monitoring borrowers' financial status in real time, providers may be better able to manage risk while providing high-quality credit to their customers.

The small-dollar credit industry should continue to develop new consumer-focused products and related services that promote consumers' financial health. We believe that the challenge of how to responsibly extend small-dollar credit can be met, and it starts with knowing the needs of the borrower.

INTRODUCTION

As CFSI defines it, high-quality credit is affordable, marketed transparently, priced fairly, structured to support repayment without creating a cycle of repeat borrowing, and supports credit-building.



An increasing number of Americans are turning to nontraditional credit sources for quick access to cash.¹ Every year an estimated 15 million people access small-dollar credit (SDC) products—payday loans, pawn loans, deposit advance loans, auto title loans, and non-bank installment loans—to meet their financial needs. And tens of millions more rely on subprime credit cards, checking account overdrafts, and other expensive forms of credit when their access to traditional credit is limited.

SDC products present both opportunities and risks for consumers. The availability of small-dollar credit can give consumers a lifeline in times of financial need. Some consumers, with very limited access to traditional credit sources and few other options, may use small-dollar credit as a best-available choice to address a pressing financial situation, such as to pay a medical bill, avoid a high-cost late fee, or prevent a service disruption. Small-dollar credit, when well structured and responsibly extended, can also help consumers purchase assets and build a positive credit history, which in turn can open doors to future wealth-building opportunities. However, SDC products often charge high fees or interest rates, can be poorly underwritten, and can put consumers at risk of falling into a prolonged cycle of indebtedness. For some consumers, using small-dollar credit may exacerbate, rather than resolve, their financial problems.

There is a critical market need for consumer-focused innovations to develop high-quality financial services that could help meet the need for short-term liquidity without the significant risks posed by many SDC products. However, high-quality innovation in the SDC market has been limited by a variety of factors including the lack of objective, data-driven research on consumers' experiences and points of view regarding SDC products. In response, the Center for Financial Services Innovation (CFSI), with funding from the Ford Foundation, has undertaken a multistage consumer research effort to examine the needs, decisions, and experiences of SDC consumers, with the goal of promoting the development of high-quality SDC solutions. CFSI defines high-quality


credit as a product that is marketed transparently, priced fairly and affordably, structured to support repayment without creating a cycle of repeat borrowing, and that supports credit-building. CFSI believes that a better understanding of why consumers turn to SDC products can encourage industry, regulators, and other stakeholders to promote high-quality credit solutions that lead to better consumer outcomes.

This report explores the financial needs that drive consumers to use SDC products—the necessary starting point for a detailed examination of the small-dollar credit market. Previous research by CFSI and others has shown that borrowers access small-dollar credit for a variety of reasons: to pay bills, cover basic living expenses, pay for an unexpected expense, or make a planned purchase. Building on this research, this report endeavors to more comprehensively identify and classify consumer demand for small-dollar credit using consumer need cases derived from quantitative and qualitative data sources.

In addition, this report seeks to offer broad recommendations for the marketplace that support the development of high-quality consumer credit products and financial services. Our findings provide further evidence that SDC consumers are not a homogeneous market that can be served with a one-size-fits-all approach. There is a clear need for a marketplace that encompasses a wide variety of credit products—as well as innovative savings and budgeting tools—to meet the varied and fluid needs of SDC consumers.

CFSI is releasing this research concurrent with ongoing efforts to create guidelines for high-quality small-dollar credit through CFSI's Compass Principles initiative. Together, through this research and the Compass Principles, CFSI hopes to create an actionable framework that providers, regulators, and other stakeholders can use to create an SDC marketplace encompassing a variety of safe, affordable, high-quality credit solutions for underserved consumers.

This report explores the financial needs that drive consumers to use SDC products—the necessary starting point for a detailed examination of the small-dollar credit market.



METHODOLOGY

Data Sources

This report relies on new analysis of quantitative data along with qualitative data on SDC consumers collected by CFSI in 2012.² The 2012 quantitative data results from a survey of 1,121 SDC users, defined as people who have used a payday loan, pawn loan, direct deposit advance, auto title loan, or non-bank installment loan of \$5,000 or less at least once in the past 12 months, . The margin of error for the overall SDC survey is +/- 4%. All statistical testing of proportions and means was conducted at the 95% confidence level.

The qualitative data consists of in-depth interviews with 31 SDC customers on their household finances, budget, history of credit use, and the circumstances related to their recent use of SDC products. The customer interviews offer additional insights into credit-related issues from the consumer's perspective and provide an opportunity to hear from SDC consumers in their own words. All names of customers used in this report are pseudonyms. (For more details on the credit product definitions and data sources, see Appendices I and II.)

In the context of this report CFSI defines the SDC products according to two general product segments: *Very short-term* and *Short-term* loans. Very short-term SDC products are payday, pawn, and direct deposit advance loans, which typically are loans under \$1,000 with a full balloon payment repayment due within two weeks to two months, and "Short-term" SDC products are installment loans and auto title loans, which are frequently larger loans (above \$1,000) and repaid in amortized installments over a period of several months to more than a year.³

Research Approach:

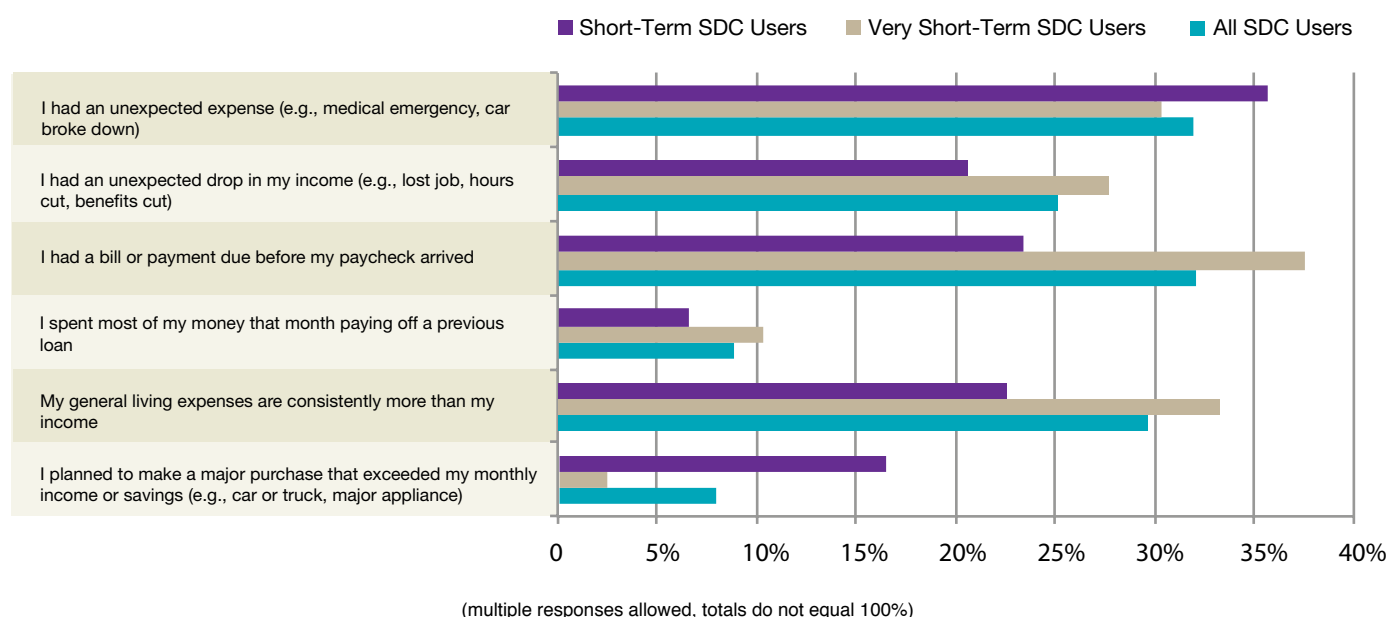
The research approach was designed to provide further insight into the range of financial needs that drive consumers' use of small-dollar credit. Most prior research of the SDC industry has focused on a specific credit product (e.g., payday loans) or loan purpose (e.g., to pay a phone bill) as a means to examine the SDC consumer and marketplace. In contrast, this research is among the first to analyze consumers' financial needs in detail across a range of SDC products. We examine how different borrowers' needs correspond to their use of credit products, overall finances, and loan outcomes. Additionally, the customer interviews provide context to understand and validate the survey data.

Data on consumers' need to use small-dollar credit from CFSI's 2012 report, "A Complex Portrait: an Examination of Small-Dollar Credit Consumers," formed the basis of this analysis. In the quantitative survey on which that report is based, SDC users were asked: "Why did you need to borrow money for this loan?" and were allowed a maximum of three responses among six categories of financial need. CFSI found that within the SDC market, consumers accessed different credit products for different needs.

This study also found that, for four of the five SDC products examined, consumers who report that "My general living expenses are consistently more than my income" are more likely to roll over their debt or extend their loan repayment. These findings underscore that the consumer's financial need has a significant influence on what credit product the borrower selects and the outcome of using that credit.

Among the six categories of credit need in the SDC survey, we selected four consumer need cases as the subject of this report. Each need case represents a unique financial need reported as a primary reason to access credit. The need cases were selected according to several criteria, including the overall frequency of survey responses (see the data for "All SDC Users" in Chart 1), the lack of overlap with other credit needs reported (see Chart 2), and the extent to which a need for credit corresponds to unique, significant loan use traits (such as use of funds, loan amount, and frequency of use) compared with other credit needs.

Chart 1: SDC Consumers' Need to Borrow

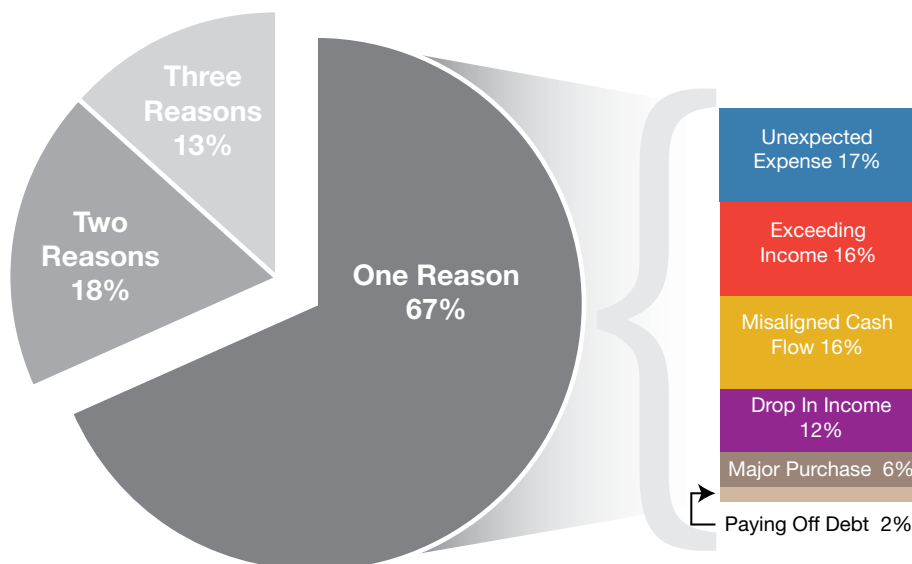


Two categories of credit need from the SDC survey—"I had an unexpected drop in income" and "I spent most of my money that month paying off a previous loan"—are less representative of a unique and primary need for credit and were therefore not selected as need cases in this analysis. Both of these reasons for using credit have a higher degree of overlap with other credit needs and lack unique loan use traits compared to the four need cases selected.

The need cases represent general categories of financial need and may not be mutually exclusive. Our analysis shows, however, that two-thirds (67%) of consumers report one reason per loan use. Furthermore, when accounting for the multiple reporting of credit needs, the need cases nevertheless correspond to specific SDC products, patterns of credit use, and the borrower's financial profile. (See Appendix III for more on the report methodology.)

Unless otherwise noted, the data presented below are for SDC consumers reporting a single credit need.

Chart 2: SDC Borrowers' Number of Reasons Reported for Credit Use



RESEARCH RESULTS:

The Four Need Cases of Small-Dollar Credit



Unexpected Expense



Misaligned Cash Flow



Exceeding Income



Planned Purchase

Based on analysis of the survey and interview data of SDC borrowers, CFSI identifies four consumer need cases.

1. Unexpected Expense borrowers tend to access credit infrequently for relatively larger expenses related to an unexpected or emergency event, such as a car repair.

2. Misaligned Cash Flow borrowers take out smaller amounts somewhat frequently to pay bills and meet regular household expenses when their income and expenses are mistimed.




3. Exceeding Income borrowers' expenses regularly exceed their income and these consumers tend to be among the most frequent users of credit, accessing small amounts for everyday expenses.

4. Planned Purchase borrowers are a smaller but important niche group of users in the SDC market who make a relatively large, planned purchase, commonly related to a personal asset.

Together these four need cases comprise the major reasons that drive consumers to use SDC products. The analysis shows that each need case corresponds to a consumer's financial profile and specific use of SDC products.

The data show that consumers' credit needs are fluid and may change over time. An SDC consumer representing one of the need cases may demonstrate another need case at another time, depending on changes in their unique financial situation. Furthermore, the financial needs that precipitate SDC use may also overlap with other financial needs. Importantly, however, the degree of fluidity between credit needs is not so common over a year (the study period of the SDC survey data) as to eliminate the significant differences among the need cases. In addition, while it is true that some consumers' reasons for borrowing may not be readily classified into a single need case, our analysis demonstrates that, on the whole, SDC consumers each tend to represent a particular borrower profile according to their primary credit need.

Table 1. Small Dollar Credit Loan Use by Consumer Need Case

Needs Case Profile	 Unexpected Expense	 Misaligned Cash Flow	 Exceeding Income	 Planned Purchase
Percent of SDC Borrowers*	32%	32%	30%	9%
Mean Household Income (pre-tax)**	\$33K	\$31K	\$27K	\$46K
Loan Uses	Car repair (32%) Medical bills (12%) Family/friend (11%) Home repairs (9%)	Utility bills (52%) Rent (24%) General living expense (23%)	General living expenses (47%) Utility bills (27%) Rent (14%)	Car purchase (37%) Furniture, appliance (17%) Business expense (13%) Home repairs (12%)
SDC Products (Type of loans used within 1 year)	Installment (29%) Payday (26%) Auto title (25%)	Payday (56%) Pawn (28%) Auto title (26%)	Pawn (41%) Payday (39%) Installment (14%)	Installment (51%) Auto title (36%)
Frequency of Use (# loans/year)	47% take out 1-2 loans 23% take out 6+ loans	23% take out 1-2 loans 42% take out 6+ loans	33% take out 1-2 loans 41% take out 6+ loans	51% take out 1-2 loans 15% take out 6+ loans
Loan Amounts	57% borrow < \$500 18% borrow \$500 - \$1K 25% borrow > \$1K	67% borrow < \$500 19% borrow \$500 - \$1K 13% borrow > \$1K	77% borrow < \$500 13% borrow \$500 - \$1K 10% borrow > \$1K	38% borrow < \$500 9% borrow \$500 - \$1K 53% borrow > \$1K
Personal Finance Ratings (self-ranking: good, fair, or poor)	66% "fair" or "good"	60% "fair" or "good"	47% "fair" or "good"	76% "fair" or "good"
Poor Credit Score (% self-ranking 1 out of 5, "poor")	16%	23%	36%	11%
Savings (% with savings prior to credit use)	50%	14%	9%	75%
Primary Credit Need Overlap	Misaligned Cash Flow (23%)	Exceeding Income (23%)	Misaligned Cash Flow (23%)	Unexpected Expense (23%)

*Includes multiple reporting of credit needs.

**Only SDC borrowers with an annual household income below \$75,000 were surveyed.

Need Case Charts: A Cross Comparison of SDC Consumer Needs and Loan Use

Chart 3. SDC Product Usage by Credit Need
(multiple responses allowed)

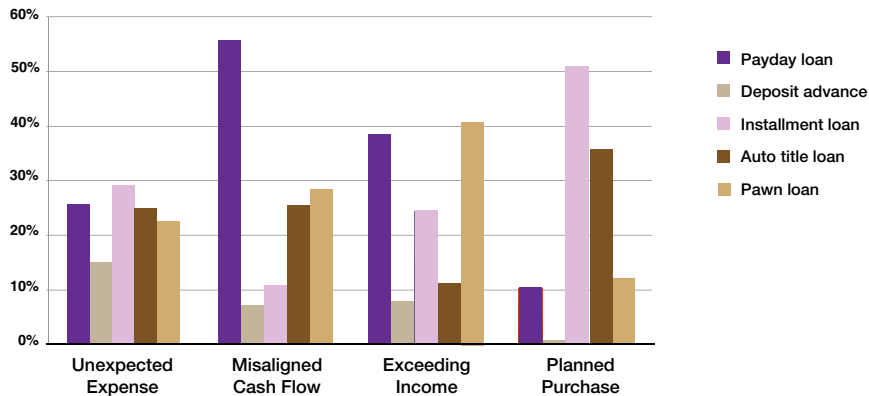


Chart 4. SDC Loan Amounts by Credit Need

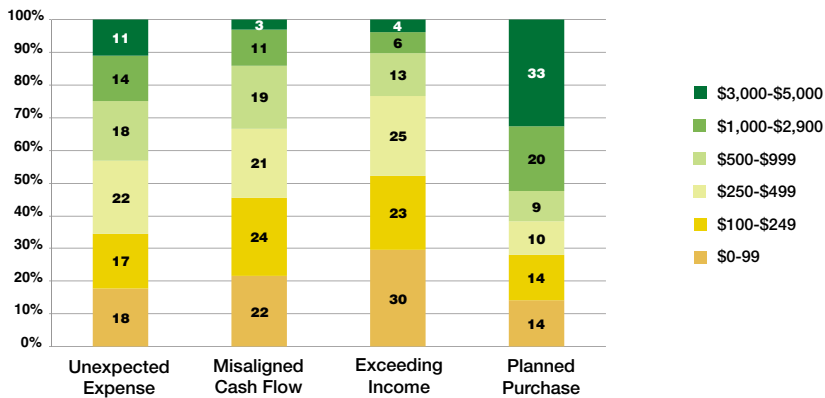
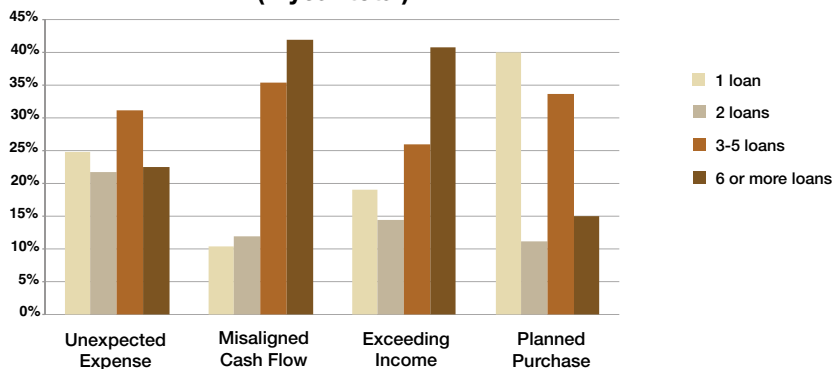


Chart 5. Number of SDC Loans by Credit Need
(1-year total)



Note: Graphs above are based on SDC borrowers reporting a single credit need (n=760).

NEED CASE 1: Unexpected Expense



With 32% of SDC borrowers saying they took out a loan to meet an unexpected or emergency expense, the Unexpected Expense is one of the most common need cases for small-dollar credit. Consumers who borrow for this reason use credit infrequently for relatively larger, unplanned expenses. In general, this borrower has a clearly defined need and utility for the loan. Some Unexpected Expense borrowers fit the oft-cited example of needing to fix his/her car to get to work, while others commonly need to pay for medicine, make a critical home repair, or help out family or friends in similar situations.

Unexpected Expense borrowers account for a significant number of loans in each of the five SDC product lines. They tend to use credit less often and may repay their debt without having to re-borrow immediately. In theory, Unexpected Expense borrowers have sufficient income to repay their debt and meet all their other expenses but may require longer terms to do so.

Despite limited access to traditional credit and their own pressing financial situation, these borrowers tend to be more financially secure than some other SDC consumers. Unexpected Expense borrowers have a slightly higher average income, a significantly higher rate of home-ownership, and better finances and credit scores than borrowers who represent the Misaligned Cash Flow and Exceeding Income need cases. In contrast to those borrowers, more Unexpected Expense borrowers rate their personal finances “fair” or “good” (66%). Furthermore, 50% of Unexpected Expense borrowers report having at least some savings prior to SDC use, and two-thirds of those with savings still have some savings at the time of borrowing. Despite their financial position and savings, these borrowers nevertheless may need additional support to build up an emergency savings cushion to be better prepared for the next unexpected expense.⁴

Need Case Summary

Use of loan funds: Unexpected Expense borrowers are significantly more likely than other SDC borrowers to use loan funds to repair a car, pay medical bills, make home repairs, and help out a family member or friend. These borrowers are less likely to use loan funds to pay utility bills, general living expenses, rent, and other loan payments.

SDC products used: Unexpected Expense borrowers commonly use all five SDC products. In particular, they access short-term loans (installment and auto title loans) more frequently than other borrowers. This suggests that many Unexpected Expense borrowers need the larger amounts and longer terms offered by short-term SDC products.

Frequency of use: Borrowers with unexpected expenses tend to access SDC credit less frequently than other users. Forty-seven percent of Unexpected Expense borrowers take out only one or two SDC loans in a year, and 77% take out five or fewer loans per year. Furthermore, nearly two-thirds (64%) of Unexpected Expense borrowers report they are “not dependent, using credit rarely”—a rate significantly higher than that of borrowers representing the Misaligned Cash Flow and Exceeding Income need cases.

Loan amount: A defining trait of Unexpected Expense borrowers is that a significant percentage takes out relatively larger loans. Almost half (43%) of consumers with an unexpected expense borrowed more than \$500, and one-quarter (25%) borrowed more than \$1,000.

Primary credit need overlap: Unexpected expenses can occur along with other financial needs. The most common area of overlap is a misaligned cash flow need, such as a bill that’s due before the next paycheck. Twenty-three percent of borrowers reporting an unexpected expense also cite a misaligned cash flow need. This finding suggests that for some consumers, an unexpected event that stresses their finances may also generate a need to cover regular household bills and expenses.

“I needed the loan because in the spring our garage door just snapped and we couldn’t get in and out of our garage. Both cars were in the garage.”

- Jon, online installment loan user



Consumer Profile: Ivy - Unexpected Expense Borrower

Ivy					
Occupation	Monthly Income	Regular Monthly Expenses	SDC Products Used	Use of Funds	Access to Other Credit Sources
Retired phone company worker	\$2,380 (pension, social security)	\$1,700 - \$2,000+	\$600 online installment loan	Repair bathroom, medicine	Mortgage (1 BR condo), no credit cards

Ivy faces a situation common among Unexpected Expense borrowers. Like many retirees with low to moderate incomes, she has a stable, fixed income but a budget with little room to absorb unexpected or irregular expenses. Ivy is careful to budget her expenses and does not regularly rely on small-dollar credit. However, her expenses—notably those related to caring for her elderly mother—may prevent her from accumulating a savings cushion to weather unexpected expenses. Instead, when such expenses occur, Ivy relies on small-dollar credit to cover her most pressing financial needs.

Who:

Ivy is a 70-year-old, college-educated, retired phone company employee who receives a pension and Social Security payments. She is divorced and lives alone in her mortgaged one-bedroom condominium in the Kansas City area. Ivy's close family includes her elderly mother and her adult son, both who live out of town.

Income and expenses:

Ivy's monthly income totals \$2,380, and her regular monthly living expenses total over \$1,700.⁵ Having dropped her Medicare-supplement insurance and later falling ill, she has seen her medical costs rise. In addition, she provides between \$200 and \$400 per month—or, in her words, “whatever's left over”—to help support her mother. She eats out at a restaurant once every other week after church. She rarely drives, relying instead on others for transportation to save gas money. Ivy has a debit card but no credit cards.

Credit needs:

Around the holidays, Ivy's delicate financial balance was shaken when she had a home emergency: A broken water main damaged her bathroom. She took out an online small-dollar installment loan to pay for repairs. She also used some of the loan proceeds to purchase medicine and set aside the remaining loan funds as a small savings cushion.

Ivy is all too aware of her financial vulnerability:

“All of these little things that pile up. The water main broke around the holidays. The bathroom was all messed up and I had to get that all taken care of. When you have a fragile budget you have to be very careful. When you retire, it is no time to have to need a new furnace, it's no time to need a new roof on your house, it's no time to need anything. Make sure everything is the way it's supposed to be, and that way you don't have any major expenses that you got to pay.”

NEED CASE 2: Misaligned Cash Flow



Misaligned Cash Flow borrowers take out SDC loans to pay bills or make payments prior to their next paycheck. In other words, borrowers need credit because their income and expenses are temporarily misaligned. In theory, although these consumers don't have the funds to meet short-term financial needs, they are likely to have sufficient funds from future income to pay off their debt and meet all other expenses.

A significant number (32%) of consumers in the SDC market report a cash flow need for credit to cover regular expenses. Among all SDC consumers, Misaligned Cash Flow borrowers tend to access credit the most frequently. Typically they borrow small amounts, under \$500, to pay for bills and regular household expenses between pay periods. They tend to use very short-term SDC products in the way that many consumers use credit cards: They access credit to align income and expenses, to avoid disruption or penalties in their accounts, and to fund occasional discretionary purchases. While Misaligned Cash Flow borrowers are among the most credit-dependent users, they may be able to reduce some of their need for credit because they usually borrow small amounts. Given their frequent low account balances and the likelihood of having an unpredictable income, Misaligned Cash Flow borrowers in particular may need to better understand and manage their finances.

SDC consumers, especially Misaligned Cash Flow borrowers, experience cash flow fluctuations for many reasons. For example, they may have lower income levels and tighter budgets, variable income, and a need for improved financial management. Those with lower incomes may have little money left after covering basic household expenses and less of a cushion to cover bills between pay periods. Misaligned Cash Flow borrowers on average have household incomes nearly 25% lower (\$30,000 vs. \$40,000 per year) than other low-to-moderate-income consumers who do *not* use SDC products.⁶

Many customers with cash flow needs (e.g., those who use credit occasionally to make bill payments) also report some variability in their income—another factor that may cause a misalignment between income and expenses.⁷ For example, SDC consumers may rely on income from a primary or secondary job with varying hours worked, and some may earn occasional work-related bonuses. Furthermore, several customers using small-dollar credit for cash flow needs reported difficulty tracking or managing discretionary expenses and expressed a desire to save more for the long term.

Need Case Summary

Use of loan funds: Misaligned Cash Flow users are more likely than other SDC borrowers to use their loan funds for periodic payments of household expenses and accounts. They most commonly use credit for utility bills, rent, and general living expenses. They are much *less* likely to use funds for purposes related to the purchase or repair of a car, medical bills, or home repairs.

SDC product use: Misaligned Cash Flow borrowers are significantly more likely to access very short-term credit products—payday loans in particular—and less likely to access such SDC products as installment loans to meet their cash flow needs. This usage pattern suggests that Misaligned Cash Flow borrowers may have little access to the larger credit amounts offered by underwritten short-term products. Also, they may need credit for regular liquidity rather than longer-term financing. Relative to other SDC borrowers, Misaligned Cash Flow borrowers also prefer loan products with automatic repayment features.⁸ This suggests that, given their tight budgets, these borrowers need loan structures that support timely repayment.

Frequency of use: Misaligned Cash Flow users accessed credit more frequently than other borrowers. Roughly half are moderate to heavy credit users: 42% take out 6 or more loans within a year and 16% take out more than 12 loans per year. In contrast, only 23% of consumers

reporting cash flow needs used an SDC product once or twice in the past year. Misaligned Cash Flow borrowers also are more likely than the Unexpected Expense and Planned Purchase borrowers to report being “somewhat dependent” on credit, using it “occasionally throughout the year.” However, while Misaligned Cash Flow borrowers tend to use small-dollar credit regularly, a cash flow need does not correlate with a higher likelihood of loan rollover or immediate repeat SDC usage. Thus, while they may borrow frequently over a year, Misaligned Cash Flow borrowers do not necessarily get stuck in the cycle of debt.

“I borrowed \$500 to pay the home alarm system company. I was going to pay the whole thing off, but I paid it on down. So I just owe them \$200 now.” —

Bo, deposit advance user

Loan amount: With a mean loan amount of \$615, Misaligned Cash Flow customers also borrowed about 23% less than the overall population of SDC users.⁹ Across all five SDC products, 67% of loans to Misaligned Cash Flow users were under \$500, and 46% were under \$250.

Credit need overlap: Slightly more than half (52%) of customers who report a misaligned cash flow need also report another financial need—the highest rate of credit need overlap among the need cases.¹⁰ This suggests that consumers facing frequent cash flow shortages may also be more likely to face multiple, overlapping financial needs. Furthermore, the primary area of overlap was with expenses exceeding their income, an issue reported by 23% of borrowers with a cash flow need. Thus, some SDC consumers presenting a cash flow need in the short-term may, based on their broader financial situation, fit more precisely in the Exceeding Income need case.

Consumer Profile: Jane - Misaligned Cash Flow Borrower

Jane					
Occupation	Monthly Income	Regular Monthly Expenses	SDC Products Used	Use of Funds	Access to Other Credit Sources
Administrative assistant (full-time), customer service (part-time)	\$2,000 - \$2,400	\$1,600 - \$2,000	\$500 online installment loan, payday loans	Rent, phone bill, some discretionary expense	No credit cards (bankruptcy)

Jane uses small-dollar credit to smooth her variable income and expenses. Her income is generally sufficient to cover her expenses, but, despite working two jobs, her budget is tight, and she is often short of cash when bills come due. As a result, she relies on very short-term small-dollar credit to cover household bills and utilities, as well as to cover some discretionary expenses between paychecks.

Who:

Jane, 56, is a high-school graduate working two jobs. She works full-time as an administrative assistant for the fire department and part-time with a major hotel. She also receives a small pension from previous employment. Jane lives alone in a rented apartment. She is divorced and has an adult daughter and two grandchildren. Jane says she has made bad financial choices over the years that led her to declare Chapter 13 bankruptcy.

Income and expenses:

Jane's take-home pay (from work and pension) averages around \$2,400 per month, and her regular monthly expenses average \$1,600. She appears to be able to meet her financial obligations—most of the time—and is not routinely behind on her bills. However, that may result from the fact that she is not extended credit or payment flexibility on her essential bills and utility payments. As she says, *"I don't really have anything that lets me get behind too much."*

Her overall budget is tight, in part because roughly a quarter of her take-home pay comes from a part-time customer-service job for a hotel. Jane says of her part-time job:

"It varies. This week I only worked two days. Next week, I might work three. It just depends. ... One of the reasons I work my part-time job is so I have a little extra spending money. And another reason I work two jobs is to stay on top of bills."

Jane manages her major expenses so that they are better timed with her income:

"My rent is \$650 a month. But I pay \$325 biweekly when I get paid on my full-time job. I always send my rent next-day delivery. That's an additional cost but I don't mind paying it, because they let me split it, which helps."

In general, Jane attempts to live within her means. She does not have cable television, she does not own a car, and she pays \$50 a month for a bus pass. She contributes \$100 monthly into her 401(k) retirement account. Her apartment is mostly undecorated. In her words, *"I like certain things. If I can't afford it, I won't get it until I can."* However, she also says she could do a better job of controlling some of her discretionary expenses, especially on entertainment and occasional trips with friends, which can cost from \$200 to \$400 per month.

Like many consumers, Jane also has irregular expenses related to family. She occasionally provides financial help to her recently divorced daughter and spends around \$500 annually on Christmas and birthday gifts for her two grandsons.


Credit needs:

For Jane, SDC products provide the liquidity needed to help her through periodic cash flow shortages. Because of her past credit history, she has no credit cards and instead occasionally relies on payday and pawn loans to address her financial needs. Her cash flow shortages result from a tight budget, variable income, irregular expenses, and occasional splurges. Jane's first payday loan was to avoid a service disruption and to fund a discretionary entertainment expense: *"I had got behind on my phone bill. And plus I wanted to go out of town, and needed some money for that."*

On her credit use, Jane admits:

"I probably could budget better, but with the two incomes coming in, I'm lax on certain things. I have a savings account but I can't seem to keep it in there too long. I don't consider myself as low-income, but I made some bad choices in my life to where I didn't budget my money the way it should be. Somebody like me, I should have money in the bank. I shouldn't have to struggle. I shouldn't have to go get payday loans because right now I am working two jobs."

When it comes to repaying her SDC loans, Jane likes a flexible repayment schedule. Sometimes she repays her loans in full, and sometimes she makes multiple partial payments. She values the ability to schedule payments around her payroll cycle, helping her to avoid late fees.



"I don't consider myself as low-income, but I made some bad choices in my life to where I didn't budget my money the way it should be. I shouldn't have to go get payday loans because right now I am working two jobs."

NEED CASE 3: Exceeding Income



Exceeding Income borrowers are the highest-risk consumers, and their use of credit presents a unique set of challenges for the SDC marketplace. By definition, this need case is represented by people who, based on their current financial situation, do not have the ability to repay their debt and meet other financial obligations. Yet they are among the most credit-dependent customers and have the fewest options to meet their financial needs. Exceeding Income borrowers tend to have the lowest income, the least access to credit, and the most financial challenges. These borrowers are the least likely to have any savings (9%) and the most likely to rate their financial situation as “poor” (58%). They are also more likely than other borrowers to be looking for work or not working because of a disability.

Like Misaligned Cash Flow borrowers, Exceeding Income borrowers use very short-term SDC products regularly. However, compared to other SDC consumers, Exceeding Income users take out even smaller loans (most under \$250) to pay for regular living expenses and basic necessities, such as food. Furthermore, Exceeding Income users have the least ability to retire a small-dollar loan within the term on the loan and thus are the most vulnerable to a pattern of repeat, dependent small-dollar credit use. A regression analysis found that Exceeding Income borrowers are the most likely to end up in a rollover or repeat-use debt cycle across four of the five SDC products we examined.¹¹

In general, Exceeding Income borrowers are in a financially precarious position. To improve their financial lives, they have a critical need for other financial services and interventions, such as income supports, financial counseling, and better savings products and practices. Unless their cash flow shortages are temporary, however, small-dollar credit may not be the right solution to their longer-term financial needs. The use of small-dollar credit—especially when offered at high cost under very short terms—may do more harm than good for these consumers.

Need Case Summary

Use of loan funds: As noted, Exceeding Income borrowers are, in some respects, similar to Cash Flow borrowers: Both use loan funds frequently to pay for recurring expenses, including utilities and rent. However, Exceeding Income borrowers are significantly more likely than others to use the loan funds for general living expenses, such as food and clothing—47% use SDC for such expenses, compared with 23% for Misaligned Cash Flow borrowers. This reliance on small-dollar credit to provide for basic needs indicates a precarious financial situation.

SDC products: Exceeding Income borrowers are most likely to use very short-term SDC—payday and pawn loans in particular. Use of such products may reflect limited access to the short-term credit products that are underwritten (such as installment loans) or secured by a larger asset (such as auto title loans). More than other SDC users, Exceeding Income credit users seek the ability to roll over or extend their short-term loans repeatedly.¹²

Frequency of use: Exceeding Income borrowers, like Misaligned Cash Flow borrowers, tend to be heavy users of SDC.¹³ Forty-one percent took out 6 or more loans per year, and 16% took out 12 or more. These borrowers are the most frequent to report that they are “somewhat dependent” or “very dependent” on credit use. In contrast to Misaligned Cash Flow borrowers, Exceeding Income borrowers are the most likely to be repeat borrowers and to roll over SDC loans.

Loan amount: Exceeding Income borrowers typically borrow smaller amounts. More than three-quarters (77%) of loans they took out were under \$500, and 30% were under \$100. The small loan size may reflect the use of credit to meet basic needs with smaller price tags, but it may also represent difficulty in accessing more credit.¹⁵

Primary credit need overlap: The most common overlapping credit need reported by Exceeding Income borrowers is with misaligned cash flow, reported by 25% of these users. This data points to the persistent challenge to separate the apparent Misaligned Cash Flow borrowers from those who regularly exceed their income and may be unable to repay debt.

“We are behind on the two car notes. We try to pay something and we pay what will keep them from coming to get the car. I’m torn between telling them they can have the one back, but then that’s another blemish on the credit report.” — Pam, payday loan and deposit advance user

“When I get through taking care of the things I have to, I generally have a little left over, but it’s not always enough to last through the whole month.” —

Anita, payday loan and online installment loan user

Consumer Profile: Nicole - Exceeding Income Borrower

Nicole					
Occupation	Monthly Income	Regular Monthly Expenses	SDC Products Used	Use of Funds	Access to Other Credit Sources
Debt collections	\$2,000 - \$2,300	\$2,200	Payday loans, deposit advance loans	Car insurance, grandmother's medicine/bills	Store credit card only

Nicole regularly needs credit to fund household bills and periodic payments. However, a review of her monthly budget reveals that her regular income may be insufficient to meet her expenses. Furthermore, she says she can't afford to retire her current debt and repeatedly uses very-short term SDC products.

Who:

Nicole, 27, works full-time in the debt collections department of a bank. She is divorced with no children and recently moved in with her grandmother.

Income and expenses:

Nicole's take-home pay varies because of work bonuses, but most recently she earned \$2,100 a month, and her regular monthly expenses were approximately \$2,200. Nicole does not pay rent, but she pays approximately \$400 per month for household bills and for some of her grandmother's personal expenses, including medicine. Nicole's largest category of expenses is related to her car, including a car payment, insurance, and gas, accounting for \$730 in expenses every month.

After covering her monthly expenses, Nicole says, "Most of my check is gone." She could not readily account for her entertainment and discretionary expenses: *"I don't even know how much money I spend—the rest of the money, I guess."*

Credit needs:

To help pay for her grandmother's bills, Nicole recently took out a payday loan:

"I had to help my grandmother and I didn't have enough money to do that. One of her bills was high and I just went and got the [payday] loan."

Unable to retire her payday loan debt, Nicole has renewed the loan every two weeks for several months. More recently, Nicole purchased a car and then owed a down payment on her auto insurance. Since then she has used a deposit advance product to make an insurance payment and, at the time of her interview, had used the product for six additional advances.

Nicole is an example of a person who appears to use credit for regular household expenses that are ill-timed (e.g., auto insurance down payment), but whose regular expenses may actually exceed her income. Nicole's experience with payday loans is an example of a very short-term credit product used, in effect, as an open-ended line of credit. Although credit may help smooth fluctuations in her income, her tight budget—much of it devoted to car-related and household expenses—together with her lack of personal expense accounting, contributes to her cash flow shortages and suggests the need for better personal financial management.

NEED CASE 4: **Planned Purchase**



Planned Purchase borrowers are a niche category (9%) of SDC consumers whose credit use differs in significant ways from that of other SDC users. Planned Purchase borrowers are the least frequent borrowers and take out the largest loans. They also more commonly report their credit need (to make a major purchase) independently of other reasons to use small-dollar credit. Furthermore, their credit use is, by definition, planned—as opposed to a response to unexpected or emergency event—and it is often related to a purchase or improvement of a major asset such as a car, house, or small business.

In some aspects, the Planned Purchase borrower presents a need for credit products similar to that of the Unexpected Expense borrower: Neither is a regular SDC user, both are less credit dependent, and when they do access credit, they tend to need larger loans. However, because they access the largest loans (33% borrow over \$3,000), they may need even longer-term financing than the other need cases.

Relative to other SDC borrowers, Planned Purchase borrowers tend to be more financially stable and better able to repay their debts. They have the highest relative income and are the most likely to have savings. Indeed, these borrowers represent the highest number of SDC consumers rating their financial situation as either “good” (22%) or “fair” (53%). They are also the most likely SDC users to have a home mortgage or an auto loan. Borrowers in this need case may have the greatest near-term potential to improve their financial situation. They in particular may benefit from credit-building opportunities that facilitate access to credit with better terms and pricing, and that provide access to conventional financing.

Need Case Summary

Use of loan funds: Planned Purchase borrowers were the most likely to use loan funds to purchase a car, make home repairs, buy furniture and appliances, and cover small business expenses.

SDC products: These borrowers predominately use short-term credit products—installment loans in particular. This suggests that they often qualify for underwritten and secured forms of SDC credit that offer larger loans. In contrast to other SDC borrowers, Planned Purchase borrowers show a particular need for longer loan terms and a fixed, certain repayment schedule to finance a purchase. They also value the availability of quick access to cash less than other borrowers.¹⁶

Frequency of use: Planned Purchase borrowers share similarities with Unexpected Expense users, though Planned Purchasers accessed credit even less frequently—most often only once or twice a year. Planned Purchase borrowers are unique in that they are less credit dependent and better able to avoid or defer a purchase with credit use. Roughly one in four (26%) of Planned Purchase borrowers report that if denied access to their recent SDC product, they would not borrow and not make the purchase—a rate significantly higher than the average for SDC consumers (3%).

Loan amount: Planned Purchase borrowers use larger credit amounts, usually between \$1,000 and \$5,000. They represent the only need case in which a significant number (33%) borrow more than \$3,000 per loan.

Primary credit need overlap: Notably, Planned Purchase borrowers were the least likely to report multiple categories of credit need, with 68% reporting they borrowed exclusively for their planned purchase. This suggests that the need to make a planned purchase, although less commonly reported by SDC consumers

overall, is both a unique and primary reason for using small-dollar credit. However, 23% of borrowers reporting a planned purchase also cite a financial need resulting from an unexpected expense. This overlap of credit needs implies that, for a segment of borrowers, a single financial issue may present both unexpected and planned reasons to spend, while for others, it may represent two distinct credit needs that occur simultaneously.

“I needed the loan to make the down payment on my car. And I wanted money to take a trip with my sister.”

—Luis, installment loan user



Consumer Profile: Daniela - Planned Purchase Borrower

Daniela					
Occupation	Monthly Income	Regular Monthly Expenses	SDC Products Used	Use of Funds	Access to Other Credit Sources
Janitor	Two full-time incomes (including husband)	Rent, food, phone, utilities, public transportation, remittances, child care	Installment loan	Summer camp, travel, home addition	Cancelled credit card

Daniela represents an example of a Planned Purchase borrower. She needs to pay summer camp fees for her child. She is not a regular credit user, and she says she stays on top of most expenses. However, with a fixed income and a need to provide for relatives back home, she cannot always meet some of the larger costs of raising a family.

Who:

Daniela, 35, is a working mother who lives with her husband and their 10-year-old son in a rented apartment in the San Francisco, CA area. She moved from Mexico to the Bay Area 12 years ago and has worked full-time for 9 years as a janitor cleaning offices.

Income and expenses:

Between her husband's full-time income from a job in construction and Daniela's monthly paycheck, her family can generally cover basic expenses without regularly using credit. Their household budget is tight, and Daniela does what she can to keep her expenses low. For example, Daniela and her son rely on public transportation, and she has birthday parties at home instead of in a rented location.

Credit need:

Between rent, utilities, and food, and occasionally sending funds to family in Mexico, Daniela has little opportunity to accumulate savings. Her credit score had dropped because she had canceled a credit card that charged high fees and interest. Daniela used her first loan from a retail installment loan company to make the full down payment for her son's summer camp.

"During the summer, I have to find someone to take care of my son. Here in San Francisco, you sign up your kid in March for the summer camps and you pay the full amount. I found out that they charge \$1,400 for 10 weeks. Paying the full \$1,400 up front is not so easy to do. I mean, I work, my husband works, but we still have to pay the rent and bills and we didn't have the money in that moment."

Daniela has used installment loans twice since then to fund other planned, non-emergency purchases related to her family or a major asset. She used the second loan to put funds aside for future summer camp expenses, as well as for family travel to Mexico and a savings cushion. Her third installment loan helped cover some of the costs of building a small house for her mother in Mexico.

CONCLUSION: MEETING THE NEEDS OF SMALL-DOLLAR CREDIT CONSUMERS

This report, a needs analysis of SDC consumers, is intended to inform the development of high-quality credit products and other financial services that promote success and create opportunity for millions of SDC borrowers. The analysis shows that listening to their need for credit provides a meaningful framework to identify and classify SDC consumers in the marketplace. The findings can also serve as a useful starting place to understand the tens of millions of additional borrowers who access credit through other subprime credit products.

Many SDC consumers could benefit from financial management solutions and innovative approaches to help them better budget and save. Financial services that help consumers reduce cash flow shortages and help build emergency savings have great potential to address the underlying financial needs that drive many SDC consumers to use credit.

The analysis also suggests that a variety of safe, affordable, high-quality credit products are necessary to meet some of the need cases in the SDC market. There is no one-size-fits-all solution to consumer credit. Instead, the four need cases described present opportunities to customize credit features and delivery channels to reach the various SDC consumer submarkets.

While this report does not offer specific product design recommendations, the research can provide a foundation for consumer-focused innovations in the SDC marketplace. Targeted research and more specific product frameworks beyond the scope of this report will best support the development of high-quality credit, and CFSI's forthcoming Compass Guide to Small-Dollar Credit will advance this effort by defining quality standards for the entire SDC industry.

Below we summarize our initial observations from the analysis of SDC borrowers' financial needs:

- **Unexpected Expense** borrowers. These consumers need infrequent but accessible loans of both large and small amounts. They may benefit from amortized installment loans with extended terms that facilitate repayment within their monthly budget.
- **Misaligned Cash Flow** borrowers. Because of a misalignment of income and expenses, these borrowers frequently need access to small-dollar credit products. They may be better served through low-limit, open-ended credit lines that are both flexible and structured to support repayment.
- **Exceeding Income** borrowers. These consumers are the most financially at-risk. They reveal an industry-wide need for better underwriting practices and more comprehensive non-credit solutions, such as income supports, savings, and financial management.
- **Planned Purchase** borrowers. These consumers rely on longer-term credit to finance larger loans for major purchases and asset building. They may benefit from products that support credit building and graduation to conventional credit sources.

The four need cases identified in this paper present a new way to explore the challenge of when and how to responsibly extend small-dollar credit. Notably, this analysis highlights an important role for better underwriting in the SDC industry. Cash flow shortages that drive credit use may be recurrent but short term, as with Misaligned Cash Flow borrowers, or they may represent a longer-term, ongoing problem and indicate an Exceeding Income borrower. Determining borrowers' ability to meet expenses and repay debt is crucial for identifying credit needs and who can successfully repay a loan, and is a critical underpinning of high-quality credit.

Identifying income shortfalls is challenging for SDC providers, especially in the very short-term credit marketplace, where both lenders and borrowers are motivated to make quick transactions. These realities point to the need for streamlined methods during the underwriting process to capture and analyze a borrower's recent financial history, including expenses and debt payments. While a challenge unto itself, better and more comprehensive underwriting can lead to more complete understanding of consumers, a solid foundation upon which to build new and better products and services that improve consumer outcomes.

Furthermore, the fact that consumers' financial lives change over time underscores that even the best underwriting practices are not sufficient to ensuring success for consumers and providers alike throughout the course of a loan. SDC lenders that can accurately monitor the financial status of their borrowers in real time, and offer flexibility and helpful customer service in response to inevitable changes in borrowers' financial situations, will be best positioned to manage their own risk and prevent some of the more harmful consequences of credit use.

The small-dollar credit industry should continue to develop new consumer-focused products and related services, with an emphasis on serving consumers' financial needs and promoting their financial health. This research is intended to offer one new approach to achieving that goal through a closer examination of consumer needs. Additional consumer research will be critical to better understand the demand for small-dollar credit as well as other aspects of consumer credit use, decision-making, and outcomes. We believe that the challenge of how to responsibly extend small-dollar credit can be met, and it starts with knowing the needs of the borrower.

APPENDICES

I. Small-Dollar Credit Product Definitions

In selecting the small-dollar credit products in this and prior analyses, CFSI considered nontraditional products used primarily by credit-constrained consumers. We examined the following five products:

Payday loans: Loans of generally \$300–\$500 with full repayment due two weeks after the date of the loan. Payday loans come with a flat borrowing fee, typically between \$15 and \$20 per \$100 borrowed. When the loan is made, lenders typically obtain a post-dated check for the amount of owed principal and fees or receive electronic access to a customer's checking account. If the loan is not repaid at maturity, the lender has the option to cash the check or withdraw from the account as a means of repayment.

Pawn loans: Loans of typically a few hundred dollars or less with a maturity of around 30 days and a borrowing fee of approximately 20% of the loan's value. The loans are secured by physical items such as jewelry or electronics that customers provide to lenders when the loan is made. If the loan is not repaid, the lender may sell the item.

Direct deposit advance loans: Loans or advances offered as add-ons to checking accounts. These products allow customers to borrow against a credit line—typically \$500 to \$1,000—with funds transferred to their transaction account and repaid via an automatic deduction when they receive their next direct deposit payment. Customers are typically charged a flat borrowing fee of \$7.50–\$10 per \$100 loaned.

Installment Loans: Loans ranging from several hundred to several thousand dollars offered by nonbank providers and repaid in a series of installments. The length of the loan repayment fluctuates depending on the amount borrowed and borrower preference but is typically 6 to 18 months. Borrowers are charged periodic interest over the

life of the loan, with annual interest rates ranging from 20% or 30% for larger, longer loans to over 200% for smaller, shorter loans.

Auto title loans: Loans offered by nonbank providers and secured by the title to a used car. Borrowers keep the car during the loan term, but lenders may take possession of it if the borrower defaults. Loan sizes are typically near \$1,000 but can range from a few hundred dollars to over \$2,500, depending on the value of the borrower's car and state regulations. Borrowing fees are typically in the range of 10% to 25% of the loan value per month. Traditionally, loans have been structured as one-month loans with a single repayment, but many lenders offer longer-term loans through installment repayment plans, interest-only repayment plans, or open-ended lines of credit secured by auto-titles.

II. Data Sources

A. Small-Dollar Credit Quantitative Dataset

CFSI's SDC quantitative data comes from a survey of 1,121 small-dollar credit users, defined as people who, in the past 12 months, have used a payday loan, pawn loan, direct deposit advance, auto title loan, or non-bank installment loan of \$5,000 or less at least once. The SDC quantitative data was gathered by an online consumer survey conducted by GfK between January 5 and January 27, 2012. Survey respondents were randomly sampled from GfK's KnowledgePanel®, which is statistically representative of the U.S. population, of adults ages 18 and over with household incomes below \$75,000.

The survey collected data on various issues related to consumers' use of credit, including the reasons that consumers report for using credit. The margin of error for the overall SDC sample is +/- 4%. All statistical testing of proportions and means was conducted at the 95% confidence level, and all subgroup findings are

representative of that particular subgroup. Comparisons made between subgroups within the text of this paper are statistically significant, unless otherwise noted. Data in the tables and charts are reported as received and may be directional but not statistically significant when comparing among subgroups. Additional information on GfK KnowledgePanel® is available online at <http://www.knowledgenetworks.com/knpanel/>

Additional Information on Survey Question Related to Consumers' Credit Need

The consumer needs analysis is based in part on consumers' answers to survey question #9: "Why did you need to borrow money for this loan?" Respondents could choose up to three selections from the following options (order of presentation randomized):

- I had an unexpected expense (e.g., medical emergency, car broke down)
- I had an unexpected drop in my income (e.g., lost job, hours cut, benefits cut)
- I had a bill or payment due before my paycheck arrived
- I spent most of my money that month paying off a previous loan
- My general living expenses are consistently more than my income
- I planned to make a major purchase that exceeded my monthly income or savings (e.g., car or truck, major appliance)
- Another reason (please specify)

The six categories of credit need listed in question #9 were developed based on consumer data reported in CFSI's 2008 Underbanked Consumer Study, which identified specific reasons and purposes for which underbanked consumers used credit within the last year—for example, to pay a medical bill, to pay rent, or to fix a car.

B. The Small-Dollar Credit Qualitative Data

The qualitative dataset consists of in-person, in-depth interviews with 31 borrowers of three nontraditional small-dollar credit products. To construct a sample of borrowers, CFSI selected credit providers that offer a credit product with at least one unique or potentially

innovative feature intended to meet the needs of underserved customers. The interviews queried SDC customers on their household finances, budget, and general use of credit, in addition to the circumstances that led customers to use the particular SDC product in question.

Please note that selection in the research study represents neither an endorsement of the company nor a statement by CFSI about the overall quality of their credit product. The selected SDC products chosen for the customer interviews were:

- ZestCash, an alternative online small-dollar installment loan;¹⁷
- Regions Bank's Ready Advance™, a deposit advance product; and,
- Progreso Financiero, a retail-based installment loan product.¹⁸

Lenders provided a list of potential interviewees according to CFSI's established criteria, which require that a significant number of repeat credit users be included in the sample. The research team, led by University of Washington Associate Professor Jennifer K. Romich, PhD, and assisted by social work practitioner and researcher Jody Miesel, ultimately selected candidates from the eligible pool of customers. The research team conducted one- to two-hour in-depth interviews (IDI) between May and September 2012. The ZestCash customers interviewed were located in Kansas City, Missouri; the Regions Bank customers were in Birmingham, Alabama; and the Progreso Financiero customers resided in California's San Francisco Bay Area.

Qualitative Interview Questionnaire

This individual in-depth interview asked 31 small-dollar credit users questions in a semi-structured format on the following areas:

- Borrower demographic information
- Personal financial background
- Monthly income and expense calendar
- Payment methods and services used
- Credit history
- Annual financial calendar
- Past credit product use
- Recent credit product use

III. Needs Analysis Methodology

A need case is defined in this analysis as a primary and unique reason for using small-dollar credit. Data from the SDC survey was analyzed to determine the need cases according to the following criteria: the overall frequency of survey responses, the lack of overlap with other credit needs, and the extent to which a credit need corresponded to unique, statistically significant loan use traits based on both the most recent SDC uses and all SDC use within a year. In addition, selection of the need cases was informed by the SDC qualitative interview data and by our general knowledge of the underserved credit marketplace.

A. Multiple Responses to Credit Need

The large percentage (67%) of small-dollar credit users reporting a single need for using credit favored an analytical approach based on distinct categories of credit need. One potential limitation of the needs-based analytical approach is that some consumers have multiple financial needs that precipitate credit use, as evidenced by the significant number (33%) of respondents reporting multiple reasons for using credit. To account for the potential influence of consumers with multiple, overlapping financial needs on the customer needs analysis, the quantitative data from all SDC users (including those with multiple needs) were compared with those SDC users reporting a single reason as their credit need. Our analysis found that consumers' responses related to loan use (credit product

used, frequency, and amount) were in general statistically significant in both groups of credit need (multiple and single credit needs), although the results tended to be more pronounced among those reporting a single credit need. These findings further supported the needs analysis approach according to distinct categories of credit need.

B. Determining the Need Cases from Other Reasons to Use Small-Dollar Credit

Unexpected Drop in Income

Our analysis rejected this as a need case because it tended to overlap more frequently with other credit needs (57% of consumers reporting this credit need also reported another credit need) and because it lacked unique loan use traits. Our analysis was also informed by our general understanding that the circumstances of consumers experiencing a decline in income better resemble one of several other need cases. CFSI's analysis of the SDC quantitative data suggests that an income reduction is a conditional dynamic that influences an SDC user's overall credit needs. The nature and timing of a customer's income variability dictates the credit need case into which the borrower fits best. Consumers who can repay their debt and meet their other financial obligations may, depending on their specific credit need and situation, fit into the Unexpected Expense, Misaligned Cash Flow, or Planned Purchase need case. Those who can't afford to repay debt on top of their regular expenses are best categorized within the Exceeding Income need case.

Money Spent Paying Off a Previous Loan

Our analysis rejected this as a need case because of its low frequency of unique responses (2%) and its high degree of overlap with other credit needs: 74% of consumers reporting this need also reported another credit need. Furthermore, we conclude that paying off a previous loan is not a primary credit need but reflects the outcome of previous use of credit.

End Notes

¹ The 2011 FDIC National Survey of Unbanked and Underbanked Households reported an increased use of alternative financial services, including payday loans, pawn loans, rent-to-own credit, and refund anticipation loans, between 2009 and 2011. Similarly, CFSI's 2011 Underbanked Market Sizing Study reported a significant year-over-year increase in industry revenue for online payday loans and pawn loans, and moderate to small increases in revenues for installment loans and auto title loans.

² CFSI gratefully acknowledges the involvement of multiple research experts in developing, analyzing, and reviewing this research, including Jennifer L. Romich, PhD, associate professor, University of Washington; Jody Miesel, social work practitioner and researcher; Rourke O'Brien, researcher, Princeton University; and Dr. Kim Manturuk, senior research associate in financial services, University of North Carolina. CFSI also thanks Progreso Financiero, Regions Bank, and ZestFinance (formerly ZestCash) for their instrumental partnership in identifying customers to be interviewed.

³ Center for Financial Services Innovation, "A Complex Portrait: An Examination of Small-Dollar Credit Consumers," 2012.

⁴ When asked if they would borrow again using their recent SDC product, and prompted with three responses—"Yes, without hesitation," "Maybe, if I have no better options," and, "No"—58% of Unexpected Expense borrowers replied: "Maybe, if I have no better options"—the highest rate among the need cases.

⁵ Regularly occurring expenses include housing, utilities, communication, transportation, food/groceries, and healthcare as reported by interviewee. Note: Food/grocery expenses were not detailed by this interviewee but were estimated at \$200 per month based on other similar customer data.

⁶ The mean 2011 household income for Misaligned Cash-Flow users in the SDC survey data was \$30,000, compared with \$40,000 for the non-SDC users in the sample. Note: The survey population was limited to a proxy low-to-moderate-income population of households with income below \$75,000 per year.

⁷ For reference, 9 of the 31 SDC customers interviewed for the qualitative data reported variation in income.

⁸ Misaligned Cash Flow borrowers rated the loan attribute "Repayment is Automatic" (3.49 mean rating on a 1 to 5 scale) significantly higher than the mean rating for this attribute by all SDC users (3.29).

⁹ Mean loan amount reported for all SDC customers was \$795.

¹⁰ Differences in credit need overlap between need cases are directional but not necessarily statistically significant.

¹¹ See "Additional Information on Regression Analysis of Factors Contributing to Rollover or Loan Extension" in the Appendix to CFSI's "A Complex Portrait," pp. 29-30.

¹² Those reporting that they exceed their income rate their "Ability to rollover or extend loan" as a 3.68 on a 1 to 5 scale, a rating significantly higher than the 3.48 rating given by all SDC users.

¹³ Differences in loan use frequency between Misaligned Cash Flow borrowers and Exceeding Income borrowers are overall small and within the margin of error. Thus, we conclude that both need cases represent the most frequent borrowers in the market.

¹⁴ Forty-one percent of Exceeding Income borrowers reported being "Somewhat dependent on credit, I need it on occasion throughout the year" or "Very dependent on credit, I rely on it on a monthly basis," compared with 33% for all SDC users.

¹⁵ Twenty-one percent of Exceeding Income borrowers said they borrow "less than what was needed," a rate significantly above the response rate of 16% for all SDC users.

¹⁶ The most important loan attributes for Planned Purchase borrowers are "clear terms/knowing exactly what I'll pay" and "the term or length of the loan." Differences in loan attribute rankings for Planned Purchase borrowers are directional, but not necessarily statistically significant.

¹⁷ Founded in 2009, ZestCash provided online short-term installment loans until June 2012. ZestCash installment loans are currently not available in the small-dollar credit market. Underwriting capabilities, first employed for ZestCash products, are now the primary focus of ZestFinance, a financial service technology company that builds and licenses underwriting models to direct lenders.

¹⁸ Progreso Financiero is a portfolio company of Core Innovation Capital, a strategic partner of CFSI.

A special thanks to those who were instrumental in producing this report: CFSI staff Beth Brockland, Thea Garon, Kimberly Gartner, Jeanne Hogarth, Jessica Kumar, Rachel Schneider, Kathleen Smith Shelton, and Joshua Sledge; CFSI board member Ellen Seidman; and design consultant Jon Heiniger.



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Supported by a grant from the



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